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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966.

No. 764

BURR OAKS CORPORATION, A. AARON ELKIND AND ROSELLA ELKIND, HAROLD A. WATKINS AND FANNIE WATKINS, MAURICE RITZ AND ESTHER LEAH RITZ,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

This is a petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit entered on June 28, 1966, affirming a decision of the Tax Court of the United States. The cases of the Petitioners were consolidated below.

OPINIONS IN COURTS BELOW.

The opinion of the Court of Appeals for the Seventh Circuit (Appendix A, *infra*, pp. 21-28) is reported at 365 F. 2d 24. The opinion of the Tax Court (Appendix B, *infra*, pp. 29-56) is reported at 43 T. C. 635.

JURISDICTION.

The judgment of the Court of Appeals for the Seventh Circuit was delivered and entered on June 28, 1966. A timely petition for rehearing and review *en banc* was denied by the Court of Appeals for the Seventh Circuit sitting *en banc* on August 16, 1966 (Appendix C, *infra*, p. 57).

The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1). This Court is being petitioned to grant certiorari because (1) the judgment below is in conflict with principles applicable under decisions of this Court; (2) the questions presented in this case are of a recurring nature; and (3) the questions are of extreme importance in the proper administration of the Internal Revenue laws.

QUESTIONS PRESENTED.

1. Does a transfer of land to a corporation owned by the wives of two of the transferors and the brothers of the third in a transaction which qualifies as a sale under local law, constitute a sale in whole or in part under the Internal Revenue laws?

2. Can promissory notes given by the corporation as part of the consideration for the land, which constitute pure debt instruments under local law, be considered "stock" under the Internal Revenue laws?

STATUTES AND REGULATIONS.

The statutes and regulations involved in this case are:

Sections of Internal Revenue Code of 1954 (26 U. S. C).

Section 301(a), Appendix D, *infra*, p. 58.
Section 302(d), Appendix D, *infra*, p. 58.
Section 351, Appendix D, *infra*, pp. 58-59.
Section 1222(3), Appendix D, *infra*, p. 60.

Treasury Department Regulations under Internal Revenue Code of 1954.

Section 1.317-1, Appendix E, *infra*, p. 61.

STATEMENT OF CASE.[1]

In December of 1954, A. Aaron Elkind, Maurice Ritz and Harold A. Watkins entered into an agreement with the widow of the former owner to purchase approximately 70 acres of land being used as a golf course on the outskirts of Madison, Wisconsin ("the Burr Oaks property") for $100,000 (A. 88, 89, 159, 160). The sale was made on April 1, 1955 under a land contract providing for a down payment of $25,000 and the balance of $75,000 in quarterly installments of $5,000 plus interest of 4% per annum.

Elkind, Watkins and Ritz had participated together in one other real estate venture. In June, 1953 they purchased a farm near Madison ("the Gay farm") for $70,124.15 and then sold it in April, 1954 to a corporation controlled by Elkind and one Donald Sanford for $149,650.79 (A. 77, 86-88, 162, 163, 202).

Efforts were made by Elkind, Ritz and Watkins to develop the Burr Oaks property as a commercial area or industrial park. These efforts were unsuccessful (A. 90-93). In early 1957 Elkind and Sanford, who owned a one-third

1. References are to the Petitioners' Appendix filed with the Court of Appeals and transmitted herewith..

interest in all of Elkind's real estate development and building companies, became interested in purchasing the property as the site of a multi-purpose residential development similar to what they had done with the Gay farm (A. 94-97, 167-170, 178-182).

In 1956 the Burr Oaks property was annexed to the City of Madison. In 1957 when Sanford and Elkind became interested in acquiring the property, a preliminary plat was submitted and approved by the City of Madison, providing for 89 single family dwelling lots, 65 four-family apartment lots, 110 apartment units, one commercial area and one school site (A. 79-80, 125-126).

Based upon an analysis by Sanford of the value of the property to a purchaser planning to subdivide it in accordance with the preliminary plat, Elkind and Sanford decided to offer $360,000 for the property and Elkind made such a proposal to Ritz and Watkins. Elkind's proposition was summarily rejected because Ritz and Watkins felt that the land had a value in excess of $360,000 and they did not want Sanford and Elkind to earn excessive profits at their expense as had happened in the Gay farm transaction. When Ritz suggested that the land be sold at a higher price to a competitor of Elkind and Sanford, a controversy developed among the three owners and the disposition of the land was stalemated (A. 94-98, 167-174, 202, 203).

Under the existing circumstances Ritz decided that the only avenue open to achieve agreement among the three of them and to best serve their interests was to sell the property at the price proposed by Elkind and Sanford to a newly organized corporation to be controlled by relatives or members of the families of the three owners. Such corporation would then subdivide and improve the land and out of the proceeds from the sale of lots make payment of the purchase price. Ritz believed that his plan provided a solution to the existing problem because, first, it would

enable the owners to retain their status as investors on the sale of the property and, accordingly, derive capital gain benefits therefrom; secondly, if the property were worth more than $360,000, as he and Watkins believed, then at least family members or close relatives would enjoy the benefits of a bargin purchase, and thirdly, it would allow a sale of the property to which Elkind would consent inasmuch as it would not involve a competitor. Ritz's proposal was acceptable to Elkind and Watkins (A. 98-100).

Prior to organizing the corporation, Watkins and Ritz contacted Albert J. McGinnis, a Madison lawyer, who had developed several subdivisions for companies owned by Elkind and Sanford and who was very familiar with the Burr Oaks property, for the purpose of determining whether he would be interested in managing and supervising the operations of the corporation. After expressing his interest McGinnis made an analysis of the prices which he thought could be obtained from the sale of lots and the length of time which might be involved in disposing of the lots. McGinnis was of the view that 37 of the lots zoned for four-family apartment buildings plus the commercial land could be sold almost immediately because water and sewer facilities and streets were already available to such lots. In addition he anticipated that the city would purchase the school site within a matter of several months. It was his estimate that substantially all of the subdivision would be sold within three years. Based on such projections Ritz determined that the corporation should be capitalized in the amount of $4,500 (A. 101-102, 105-107, 188-191, 193-195).

On October 8, 1957, Burr Oaks Corporation ("the Corporation") was organized as a Wisconsin corporation having an authorized capitalization of 1,250 shares of no par value common stock. The stockholders of the Corporation, Rosella Elkind (Elkind's wife), Fannie Watkins (Watkins'

wife) and Phillip Ritz and Erwin Ritz (Ritz's brothers), purchased 450 shares of the common stock for the aggregate sum of $4,500. The Board of Directors of the Corporation consisted of Watkins, Ritz, Elkind, Fannie Watkins, Rosella Elkind and Phillip Ritz. The officers were Watkins, President, Phillip Ritz, Vice-President, and Rosella Elkind, Secretary and Treasurer (A. 76-77, 102).

On November 1, 1957 Elkind, Watkins, and Ritz assigned their interest in the Burr Oaks property to the Corporation for the sum of $360,000 of which $330,000 was represented by three notes, each in the amount of $110,000, and the balance of $30,000 represented the amount still owing under the land contract, which the Corporation assumed. The notes were of two years maturity. Interest was not payable unless the notes were not paid at maturity, in which case it accrued after maturity at the rate of 6% per annum. In November, 1957, Elkind loaned the Corporation the sum of $15,000 and in February, 1958, he loaned it the additional sum of $10,000. The loans by Elkind, plus interest, were repaid in June, 1959 (A. 100-101, 145-147, 158).

Generally, the property was improved pursuant to ordinances of the City of Madison which required the city at the request of a developer to install improvements such as sewer, streets and water in an area which is the subject of a recorded plat. Under such ordinances the city recovers its costs through special assessments which are payable over a period of between 5 and 8 years (A. 193-194, 219-220).

McGinnis was employed by the Corporation for a three year term to manage and operate the business of the Corporation. He had sole responsibility for the platting and improvement of the property, the sale of lots and the conduct of its financial affairs (A. 101-102, 188, 190, 198).

Although the lots zoned for apartments sold quickly and were sold out as anticipated, the Corporation encountered unexpected difficulties in the sale of the single family dwelling lots. As a result on December 31, 1963, 67 single family dwelling lots having a selling price of approximately $4,100 each, including all assessments, remained to be sold (A. 141, 191-192, 197).

On November 1, 1959, Elkind, Watkins and Ritz each exchanged his note for a payment of $23,000 from the Corporation and a new promissory note in the amount of $87,000 due in one year and bearing interest at the rate of 6% per annum. Such new notes were paid by the Corporation in full on December 29, 1959. To provide the Corporation with sufficient funds, Elkind, Watkins and Ritz each loaned $79,000 to the Corporation in return for a promissory note dated December 31, 1959. Each such promissory note became due one year after date and bore interest at 6% per annum. At the time of trial there was $46,000 still due upon each of said notes (A. 102-105).

Prior to the date of trial the Corporation had not paid a dividend on its common stock. The Corporation would expect to realize its profit on the subdivision from the sale of the last 10% of the lots, the proceeds from the previous sales going largely to recapture costs (A. 77, 259).

Elkind, Watkins and Ritz treated the transfer of the Burr Oaks property to the Corporation in November of 1957 as a sale, as did the Corporation. Elkind, Watkins and Ritz each reported the gain on said sale in 1959 when the Corporation made payment on the promissory notes which it had issued to them for the transfer of their interests in the property to the Corporation. Elkind, Watkins and Ritz treated the gain on the sale on their income tax returns for 1959 as long term capital gain.

REASONS FOR ALLOWING WRIT.

1.

Decision Below Conflicts With Commissioner v. Brown.

This case was decided by the Tax Court on February 11, 1965. On April 27, 1965 this Court rendered its decision in *Commissioner* v. *Brown*, 380 U. S. 563, 14 L. ed. 2d 75, 85 S.Ct. 1162, where the question of what constitutes a sale for income tax purposes was examined. On appeal to the Seventh Circuit the Petitioners argued extensively the application of the principles of *Commissioner* v. *Brown* to the question of whether the transfer of the property to Burr Oaks Corporation constituted a sale. However, the Court of Appeals made no reference to *Commissioner* v. *Brown* in its opinion. Instead, it pointed to its decision in *Kolkey* v. *Commissioner*, 254 F. 2d 51 (7th Cir. 1958), as establishing the criteria for a sale for tax purposes. We respectfully submit that the misplaced reliance by the court below on its own prior decision rather than on the ruling of this Court caused it to reach a result which is inconsistent with the views of this Court.

Importance of Question.

The importance and recurring nature of the first issue presented in this case was expressed by this Court as follows:

> "The term 'sale' is used a great many times in the Internal Revenue Code and a wide variety of tax results hinge on the occurrance *(sic)* of a 'sale'." *Commissioner* v. *Brown*, 380 U. S. at 575, 14 L. ed. 2d at 84.

In the instant case the meaning of the term "sale" is significant in determining whether the transfer of the land

gave rise to capital gains under Section 1222(3) of the Internal Revenue Code. The Tax Court and the Court of Appeals held that the transfer in substance was not a sale but was a capital contribution governed by Section 351, and, consequently, the basis of the land to the Corporation was the transferors' basis and the payments to the transferors were to be treated as dividends under Section 302(d).

Definition of Sale.

This Court in *Commissioner* v. *Brown* stated that a transaction is to be tested under general law in ascertaining whether a sale has occurred. "A sale has been defined as 'the exchange of an interest in real or personal property for money or its equivalent.' *Mansfield* v. *District Agricultural Asso. No. 6* (1908), 154 Cal. 145, 147, 97 Pac. 150." *Topzant* v. *Koshe,* 242 Wis. 585, 589, 9 N. W. 2d 136 (1943). A similar definition was approved by this Court. *Commissioner* v. *Brown,* 380 U. S. at 4712, 14 L. ed. 2d at 82.

The transaction in this case meets every requirement of this definition. The Burr Oaks property was transferred to the Corporation in exchange for three promissory notes aggegating $330,000 and the assumption by the Corporation of the transferors' obligation of $30,000 under a land contract.

Criteria of Sale Used by Courts Below.

The courts below did not consider local law but were of the view that the nature of the transaction is established by the criteria referred to in *Kolkey* v. *Commissioner,* 254 F. 2d 51 (7th Cir. 1958), which are basically the ones applied in a so-called "thin capitalization" case. We believe that the courts below were in error in so doing—first, because of a conflict with the principles enunciated in *Commissioner* v. *Brown,* and, second, because of crucial differences between this and the *Kolkey* case.

Viewing the facts in *Brown* alongside the standards prescribed in *Kolkey*, clearly shows that this Court did not embrace those standards in assaying the existence of a sale. The kind of facts in the *Brown* case which the court in *Kolkey* said militated against a sale were (1) small capitalization with the principal seller guaranteeing indebtedness of the new corporation; (2) trading on its tax exemption by the buyer; (3) stock in new corporation owned by sellers' attorneys; (4) buyer invested nothing and assumed no independent liability for the purchase price; (5) principal seller given management contract to manage business of new corporation and right to name successor; and (6) upon default sellers forgave approximately 30% of purchase money obligation.

Even without this Court's tacit rejection of the tests of *Kolkey*, we submit that the cited case is not controlling. Vital to the *Kolkey* decision was the arbitrary establishment of a grossly excessive purchase price, which assured a default on the part of the Buyer and unequivocally evinced an intention that the sellers reacquire possession of the properties sold. In fact the sellers were back in possession in less than a year. Thus, title never really passed and no sale was made under principles of general law. In the instant case there were unsold at the time of trial 67 single family lots selling for approximately $4,100 each. Since the balance then owing to the sellers aggregated $138,000, payment of the full purchase price was assured and repossession was not a factor.

Unlike the *Kolkey* case the selling price in this case was not arbitrarily determined. As Sanford's testimony shows, this was the price at which he and Elkind were willing to purchase the property. It is true that the Tax Court found that the fair market value of the Burr Oaks property was no more than $165,000. This by itself does not convert the sale into some other kind of transaction. *Union Bank* v.

U. S., 285 F. 2d 126 (Ct. Cl. 1961) (selling price more than twice fair market value); *Warren Brekke*, 40 T. C. 789 (selling price twice fair market value); *Anderson Dairy, Inc.*, 39 T. C. 1027 (selling price of 1.3 times fair market value).

Had the transaction with Sanford and Elkind been consummated and the property sold to them for $360,000, we have no doubt that there would have been no controversy between the taxpayers and the government. To hold that the characterization of a transaction as a sale is dependent upon the ability of the parties to pinpoint a price which a court subsequently will accept as representative of fair market value is wholly unrealistic. Fair market value must be determined in a valuation case in order to resolve a dispute between the parties. Experts in the art of appraisal frequently hold widely disparate views on the value of an item of property. Under the circumstances courts are called upon to reconcile these differences. However, to allow a court to substitute its judgment for that of the parties to a transaction where, as here, the price was set at the amount at which another buyer (Sanford and Elkind) had indicated a willingness to buy, would be inequitable as well as impractical. See *Janet McBride*, 23 T. C. 926.

Appreciation in Value and Capital Gains.

"Congress intended to afford capital gains treatment in situations 'typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.' *Commissioner* v. *Gillette Motor Co.*, 364 U. S. 130, 134, 4 L. ed. 2d 1617, 1621, 80 S.Ct. 1497." *Commissioner* v. *Brown, supra*, at 572, 14 L. ed. 2d at 82. Under the most narrow construction of the capital gains provisions of the Internal Revenue Code their benefits should be extended at least to the difference between the

cost of the land to the sellers ($100,000) and its value as found by the courts below ($165,000) at the time of sale. This Court expressed strong opposition to the Commissioner's approach in withholding capital gain treatment on appreciated values in a transaction qualifying as a sale under general law by describing it as "a clear case of 'overkill.' " *Commissioner* v. *Brown, supra,* at 579, 14 L. ed. 2d at 87.

Whether the excess payments over the court adjudged value are characterized as a retained income interest or the fruits of a joint venture or a profit sharing portion is immaterial. The payments not in excess should, nevertheless, qualify for capital gain treatment. See *Goldstein* v. *Commissioner,* 298 F. 2d 562 (9th Cir. 1962); *Roy J. Champayne,* 26 T. C. 634; *Arthur M. Rosenthal,* T. C. Memo. 1965-254. If the consideration is too high, an allocation of the payments between the adjudicated value of the property and the part in excess thereof (resulting in the excess being taxed as ordinary income) would be more consonant with the policy of the Internal Revenue laws to accord capital gains to the appreciation in value which accrued over a period of time than is the complete denial of capital gains. Had the parties to the sale partitioned the transaction and treated the payments in excess of $165,000 as ordinary income, we have little doubt that the transaction would not have been upset by the courts below. That the parties were unable to forecast that a court would not agree with the price that was established, should not penalize them with the harsh results that the Commissioner and the courts below would visit upon them. It is one thing to fragmentize the transaction and tax the excess payments as ordinary income, but quite another to set aside the entire transaction for tax purposes. Compare *Williams* v. *McGowan,* 152 F. 2d 570 (2nd Cir. 1945), approved by this Court in *Watson* v. *Commissioner,* 345 U.S.

544, 97 L. ed. 1232, 83 S.Ct. 848, where it was held that on the sale of a business its elements must be comminuted between capital and non-capital assets.

If the court below believed that the noteholders received something more than the appreciation in value of the property, it should have subjected such excess to ordinary income taxation as the profits of a joint venture or a retained income interest. It was not necessary for the Court of Appeals to treat what it considered an equity interest as an equity in the corporate structure. By agreement, form and relationship, it was at most an equity in the business transaction, not in the corporate ownership. As a result the income would, at best, belong to the various equities involved in the business transaction—that of the Corporation to it, that of the noteholders to them and that of the stockholders to them.

Inapplicability of Section 351.

If we are correct that the transfer to the Corporation by the sellers of all of their rights in the Burr Oaks property for a fixed price payable in money constitutes a sale for tax, as well as general law, purposes, then Section 351 of the Internal Revenue Code can not apply. *Charles E. Curry*, 43 T. C. 667, and cases cited therein. But there are other and equally cogent reasons for holding that the transaction is not governed by Section 351.

First of all, Section 351 is reflective of the purpose of Congress to exempt from recognition of gain or loss a transfer of a business or assets to a corporation in which the transferors continue "to carry on with their former business venture and assets in merely changed form." 3 Mertens, Federal Income Taxation, Sec. 20.46 at 129 (1965 rev.). Economic ownership and control of the Burr Oaks property after the transfer to the Corporation was vested in the stockholders (albeit in corporate form). Although

the former owners filled half of the positions on the Board of Directors of the Corporation and one served as President, there was no evidence of any agreement by the stockholders limiting their right to name other directors who could in turn select a new President. Unlike the situation in *Brown* v. *Commissioner, supra,* the only management contract was one given to an unrelated third party, Albert J. McGinnis. The sellers did not even retain a long-term interest in the property as mortgagees. And, finally, there is nothing which suggests that the wives of Elkind and Watkins and the brothers of Ritz were acting as their respective nominees or "alter egos". Each stockholder invested his own funds with the expectation of sharing in the residual profits from the sale of the land. With 67 lots on hand selling for approximately $4,100 apiece at the time of trial and a total of $138,000 owing to the sellers at that time, the stockholders could expect to receive a handsome return on their investment—that is, unless the treatment of the transaction as a Section 351 exchange is upheld with the consequent carryover to the Corporation of the sellers' tax basis in the land, in which case the income tax levy will consume the stockholders' profits.

Secondly, Section 351 is inapplicable because the sellers did not obtain a proprietary interest in the Corporation. Under Section 351 "stock or securities" must be received by the transferors of property to the corporation and the transferors must end up with control of the corporation. The notes in question are not endowed with the qualities commonly found in securities or other instruments representing equity interests. The notes received by the sellers in consideration for the transfer of the property were classic debt instruments under local law. They matured in two years; they represented unconditional obligations of the Corporation; interest was payable after maturity if they were not paid at that time; any interest was measured

by a percentage of the principal; payments of principal and any interest were not limited by the earnings of the Corporation; and the notes ranked equally with the claims of other creditors.

The Court of Appeals expressly stated that the sellers were not shareholders.

Their relationship to the corporation and the common shareholders was not that of owners. The notes did not give them the right of continued participation in the business of the Corporation. Neither by the intent of the parties, the form of the transaction nor the dynamics of the relationship between the parties did the notes constitute stock or securities. *LeTulle* v. *Scofield,* 308 U. S. 415, 84 L. ed. 355, 60 S. Ct. 313; *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194, 86 L. ed. 789, 62 S. Ct. 802; *L. & E. Stirn* v. *Commissioner,* 107 F. 2d 390 (2nd Cir. 1939); *Lloyd-Smith* v. *Commissioner,* 116 F. 2d 642 (2nd Cir. 1941). Accordingly, the transfer of the land to the Corporation did not fall within the purview of Section 351.

2.

Treatment of Payments on Notes as Dividends Is Contrary to Section 302(d).

The courts below held that the payments to the noteholders were taxable as dividends under Section 302(d) of the Code. Section 302(d) provides:

> (d) REDEMPTIONS TREATED AS DISTRIBUTIONS OF PROPERTY.
>
> Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which Section 301 applies.

In turn Section 301(a) provides:

> (a) In general.—Except as otherwise provided in this chapter, a distribution of property (as defined in Section 317(a) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

Thus, in order for a redemption to be treated as a distribution taxable as a dividend, there must be a distribution to a shareholder with respect to his stock. This statutory requirement is expressed in clear and unambiguous language. However, the noteholders in the instant case were not shareholders of the Corporation. Although the Court of Appeals concluded that the noteholders owned some kind of an equity interest, it did not hold that they were shareholders who owned stock in the corporation. In fact that Court of Appeals specifically stated, "The three individual appellants, *though not shareholders,* controlled the corporation's affairs." (Emphasis supplied.) 365 F. 2d 24, at 27.

Stock Distinguished From Other Equity Interest.

Not all equity interests constitute stock. Since the terms "shareholder" or "stock" are nowhere defined in a general sense in the Code or the Regulations thereunder, they must be given their ordinary meaning. *Carlberg* v. *U. S.,* 281 F. 2d 507 (8th Cir. 1960). Warrants to purchase stock are not "stock". *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194, 86 L. ed. 789, 62 S. Ct. 802. A warrant holder is unable to compel a corporation to issue stock upon the exercise of his rights where there are no authorized and unissued shares available. 315 U. S. 194 at 200, 201, 86 L. ed. 789 at 795. "Certificates of ownership" issued by a corporation in excess of its authorized capital and not purporting to be share certificates, were held not to be shares of stock. *D. C. Harnett Co.* v. *Shirah* (Tex. Com. App.), 287 S. W. 902.

In *W. D. Gamman,* 46 T. C. No. 1 (1966), the Tax Court held that not all equity interests are stock. Particularly pertinent is the following language which appears in a concurring opinion:

> It does not seem that the promissory notes involved in this case have sufficient (elements) of such character to be designated "actually stock". In the first place, they may be called on demand of the holder; secondly, the interest (which under the thin capitalization cases would be likened to dividends) is payable from the very assets of the corporation if necessary, unlimited by its earnings; and thirdly, the amount of earnings to be derived from the capital invested (interest) is an amount fixed by a percentage of the principal (or investment) which is required to be paid at fixed intervals. *I know of no State which permits the issuance of any class of stock with these characteristics.* (Emphasis supplied.)

Regulations as Guide to Meaning of "Stock".

Another reason for not equating stock with all equity interests is found in the Commissioner's Regulations. In the Proposed Regulations under Subchapter C (of which Sections 301 and 302 are a part) of the Internal Revenue Code, issued on December 11, 1954, Section 1.317-4 read as follows:

> "In general, the term 'stock', for purposes of this subchapter, includes all forms and classes of instruments representing the interest of owners of the equity interest in the corporation as distinguished from instruments representing the claim of persons whose relationship with the corporation is similar to that of creditors, generally referred to as 'securities'."

See *Carlberg* v. *U. S., supra,* n. 9 at 514.

The foregoing provision was eliminated from the Regulations as finally adopted. T. D. 6182, 1955-2 Cum. Bull. 61. See Treas. Reg. Sec. 1.317-1. It is apparent that the Proposed Regulations would have elevated all equity interests

to the status of stock. That the final Regulations omitted this definition is strongly suggestive of an abandonment of this concept by the Commissioner. Therefore, assuming for the sake of discussion that the holding that a sale had not occurred was correct, it was not enough to determine that the noteholders owned "equity interests of some kind" in order to tax the payments to them as dividends.

Importance of Meaning of "Stock" Under Revenue Code.

Since distributions pursuant to redemptions are commonplace transactions, it is extremely important insofar as the proper administration of the revenue laws is concerned for this Court to state that the express statutory requirement of a distribution to shareholders with respect to their stock is not to be ignored. The ramifications of this issue in the field of taxation are far reaching. Many provisions of the Internal Revenue Code depend on the meaning of the term "stock" for the scope of their application. Sections 301, 302, 304, 306, 311, 316, 317, 368(a)(1)(B), 1032 and 1036 are but a few. To our knowledge this is the first case where payments on instruments which were pure debt obligations under general law principles were taxed to the recipients as dividends on stock. The cases deal with the deduction to the Corporation of the "interest" payments, which is an entirely different matter. Significantly neither the Court of Appeals nor the Tax Court could cite any judicial authority for the conclusion that distributions on instruments which are not actually stock can be taxed as dividends.

CONCLUSION

Important issues are posed by this petition. Although this Court obviously felt the need for outlining the dimensions of a sale in *Commissioner* v. *Brown, supra,* the first opportunity (to our knowledge) given to an appellate court to apply its principles went unheeded. In reaching their

decision the courts below failed to give the terms "sale" and "stock" their commonly understood meanings, thus departing from the principles enunciated by this Court in construing the language of the Internal Revenue Code. *Commissioner* v. *Brown, supra,* and cases cited at 571, 14 L. ed. 2d at 82.

For the courts below to decide the issues in this case as they did, they would have had to answer the following questions in the affirmative:

1. If the purchase price placed on an asset is ultimately determined to be too high, will that fact result in denying the status of a sale to the entire transaction?

2. Does Section 351 of the Internal Revenue Code operate on a transaction which the parties intended to be a sale, when the sellers had no intention to become stockholders or own an equity interest in the corporation?

3. Does the term "stock", as used in Section 302 of the Internal Revenue Code and other provisions dealing with corporate transactions, mean any interest determined to be in the nature of an equity interest, regardless of the traditional distinctions of the corporate law?

We respectfully submit that by answering these questions in the affirmative, error was committed.

An approach, often too subtle to be easily highlighted, we believe is gaining more and more approval to the unwarranted detriment of taxpayers. It is the approach of the taxing authorities that whatever things may be for general law purposes, they may be something else for tax purposes. The result is that transactions, valid and effective under principles of general law, are after the fact destroyed or changed for tax purposes under the guise

that substance controls over form. Contracts, stockholder relationships, debtor-creditor relations, corporate structures and business transactions in general stand in peril before the taxing authorities as they exercise their discretion as to what the substance of any relationship may be, principles of general law notwithstanding. This is not to say that all transactions must be taken at face value. Where there is clear proof that a transaction has been coated with a contrived facade for appearance sake only and has no reality in general law, then it should also be disregarded for tax purposes. However, all too often taxpayers are submitting to administrative taxation even though long standing legal principles are being subverted, simply because the appellate process is too costly. It should not become standard doctrine that a sale is a sale except for tax purposes, that a note is a note except for tax purposes, and that an agreement is an agreement according to its terms except for tax purposes. We submit that well recognized precepts of general law and conventional relationships should not be disregarded in the search for additional tax revenue.

By virtue of the importance of the principles involved we are petitioning this Court to review and consider the issues raised by this case.

Respectfully submitted,

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APPENDIX A.

Opinion of the Court of Appeals for the Seventh Circuit.

IN THE UNITED STATES COURT OF APPEALS
for the Seventh Circuit.

September Term, 1965—April Session, 1966

No. 15344
BURR OAKS CORPORATION,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 15345
A. AARON ELKIND and ROSELLA ELKIND,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 15346
HAROLD A. WATKINS and FANNIE G. WATKINS,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 15347
MAURICE RITZ and ESTHER LEAH RITZ,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petitions for Review of Decision of the Tax Court of the United States.

June 28, 1966

Before KNOCH, CASTLE and KILEY, *Circuit Judges.*

KNOCH, *Circuit Judge.* The petitioners, Burr Oaks Corporation, A. Aaron Elkind and Rosella Elkind, Harold A. Watkins and Fannie G. Watkins, Maurice Ritz and Esther Leah Ritz, instituted these proceedings in the Tax Court to contest deficiencies in income taxes determined against them. Mrs. Elkind, Mrs. Watkins and Mrs. Ritz are in these cases only because joint income tax returns were filed. The cases were consolidated. The opinion of the Tax Court is reported at 43 TC 635, No. 51. The Tax Court held that the transfer of certain land by the petitioners A. Aaron Elkind, Harold A. Watkins and Maurice Ritz (hereinafter called "the individual appellants") to the corporate appellant represented a contribution to capital and not a sale. Accordingly, the Tax Court determined a deficiency against the corporate appellant for fiscal years ended September 30, 1958, 1959 and 1960. The Tax Court found deficiencies for one of the individual appellants, but also found an overpayment by all three of the individual appellants for 1959. The individual appellants have taken this appeal because of their concern as to adverse effect on future taxable years.

The three individual appellants acquired a tract of undeveloped land in 1957 for $100,000, which the appellants state to be less than the then market value.

After discarding plans to develop a regional shopping center or an industrial park, the individual appellants decided to subdivide the land, improve it and sell lots. The Burr Oaks Corporation was formed. The individual appellants transferred the land to it, and, in return, each received a two-year 6% promissory note in the principal amount of $110,000. The sum of $30,000 still due on the original purchase was entered on the corporation's books as "Mortgage Payable." Another account "Land Contract

Payable" in the amount of $330,000 represented the three notes.

At the trial in the Tax Court, the appellants' expert witness testified that the property transferred to the corporation was worth at least $360,000. The Tax Court, however, found more convincing the testimony of the Commissioner's expert witness who stated that the land had a fair market value of only $125,000. On the basis of all the evidence adduced, the Tax Court found a fair market value of not more than $165,000 at the time of the transfer.

The wives and brothers of the three appellants transferred a total of $4,500 in cash to the corporation and received common stock as follows:

Shareholder	No. of Shares
Rosella Elkind (Mrs. A. Aaron Elkind)	150
Fannie G. Watkins (Mrs. Harold A. Watkins)	150
Philip M. Ritz (Maurice Ritz's brother)	75
Erwin M. Ritz (Maurice Ritz's brother)	75

They are the only stockholders of record. The officers and directors were:

Harold A. Watkins	President
Philip M. Ritz	Vice-President
Rosella Elkind	Secretary-Treasurer

Directors

Harold A. Watkins	Fannie G. Watkins
Maurice Ritz	Philip M. Ritz
A. Aaron Elkind	Rosella Elkind

However, all control of the corporation was relinquished to the three individual appellants, who dominated its affairs, despite engagement of a manager and an accounting firm.

Without the knowledge of the shareholders or formal authorization by the directors, the corporation at times

transferred lots and parcels to the three individual appellants at no cost or at less than the amount the land would realize from sales to third parties. The Tax Court particularly noted some commercial property 70 by 120 feet transferred by a deed which purported to correct an error in the initial conveyance to the corporation.

The Tax Court decided that the three promissory notes did not represent a true indebtedness. In 1959, these three notes, in the amount of $110,000 each, were surrendered by payment of $23,000 in cash on each note, and a new one-year promissory note dated November 1, 1959, in the amount of $87,000 at 6% was given in exchange for each of these three notes. Later the same year, the corporation paid $8,000 to each of three noteholders and issued new promissory notes in the amount of $79,000. On December 29, 1959, the corporation purported to pay these notes, although at the close of business that day it had a bank balance of only $5,398.88. Immediately after such purported payment, the three individual appellant-noteholders each lent the corporation $79,000 in return for three new one-year promissory notes dated December 31, 1959, in the amount of $79,000 each. The Tax Court construes this transaction as a mere extension of the maturity date. *Cf. Arthur L. Kniffen*, 1962, 39 TC 553, 565-6. Additional payments were made to each of the three individual appellants as follows:

8/31/60	$ 8,000
1/31/61	15,000
12/31/61	10,000

leaving a balance of $46,000 due each at the time of the trial. None of the earnings of the corporation were distributed to any of the shareholders of record.

Although the appellants all treated the transfer of the land in November, 1957, as a sale, the three individual appellants reported no gain until 1959 when the corpora-

tion "paid" the promissory notes issued at the transfer. In their returns for 1959, the three reported long term capital gains of $85,729.06. The Commissioner determined that this was ordinary income. The Commissioner increased the corporation's taxable income for 1958 through 1960 on the ground that the corporation claimed too high a basis or cost for the land it sold during that period.

The Tax Court considered the "notes" to be preferred stock because the three holders occupied a preferred position compared to the common stockholders, the 6% interest constituting a prior charge on the earnings of the corporation.

The three individual appellants contend that they transferred the Burr Oaks property, a capital asset held in excess of six months, to the corporation in return for promissory notes, valid indebtednesses incurred by the corporation, resulting in gain properly reportable in 1959 when the notes were paid in full. The Tax Court noted that the three individual appellants were all cash basis taxpayers who should have reported as income the fair market value of the notes received in exchange for the property sold. *Pinellas Ice Co.* v. *Commissioner*, 1933, 287 U. S. 462, 468.

The corporation asserts that it bought the Burr Oaks property at a cost of $360,000 and that that should be its correct basis.

The Tax Court disregarded the form of the transaction and determined the substance of it to be not a sale but an equity contribution. Substance, rather than form, is the controlling factor in determining proper tax treatment. *Sherwood Memorial Gardens, Inc.*, 42 TC 211, 1964, on appeal 7 Cir., 1965, 350 F. 2d 225.

The Tax Court found the transfer lacking the essential characteristics of a sale, but, on the contrary, possessed of the elements normally found in equity contribution. See

Emanuel N. Kolkey, 1956, 27 TC 37, affirmed, 7 Cir., 1958, 254 F. 2d 51. In that case, certain criteria were established:

> Was the capital and credit structure of the new corporation realistic? What was the business purpose, if any, of organizing the new corporation? Were the noteholders the actual promoters and entrepreneurs of the new adventure? Did the noteholders bear the principal risks of loss attendant upon the adventure? Were payments of "principal and interest" on the notes subordinated to dividends and to the claims of creditors? Did the noteholders have substantial control over the business operations; and, if so, was such control reserved to them, as an integral part of the plan under which the notes were issued? Was the "price" of the properties, for which the notes were issued, disproportionate to the fair market value of such properties? Did the noteholders, when default of the notes occurred, attempt to enforce the obligations?

In this case, the corporation was organized with a paid-in capital of only $4,500, but shortly thereafter reflected liability of $360,000 on its books. Although it was anticipated that the City of Madison, Wisconsin, would pay the major costs of improvement of the tract to be subdivided, the corporation would have to incur development costs estimated at $100,000 or more. Within two months, the corporation borrowed $15,000 from individual appellant Aaron Elkind and on February 28, 1958, borrowed another $10,000 from him. Although the taxpayers assert that a number of lots were ready for sale and that heavy capitalization was therefore unnecessary, the sales were not so quickly made as to eliminate the need to borrow. The land was the corporation's only asset.

When the payment to the transferors is dependent on the success of an untried undercapitalized business with un-

certain prospects, a strong inference arises that the transfer is an equity contribution.

The three individual appellants, though not shareholders, controlled the corporation's affairs. Harold Watkins was president. Aaron Elkind, his wife, Maurice Ritz, his brother Philip, Harold Watkins and his wife were directors. The manager had been employed by Aaron Elkind in varying capacities for about 15 years. His activity was supervised by Maurice Ritz's accounting firm.

After hearing the testimony of the shareholders, Maurice Ritz's brothers, Mrs. Elkins and Mrs. Watkins, the Tax Court was convinced that they knew and understood little of the corporation's business and were subject to the control of the three individual appellants. Two of the latter agreed that the corporation was formed to allow them to receive a part of the development profits. The large "sales price" extended the time during which the three individual appellants participated as "creditors" and the amounts they could withdraw as principal if the corporation were successful.

Section 351(a) of the Act provides:

> **Transfer to corporation controlled by transferor**
>
> **General rule.**—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

Section 368(c) defines "control" as meaning:

> * * * ownership of stock possessing at least 80 percent of the total combined voting power of all classes

of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

The three individual appellants challenge the finding that they controlled the corporation as their "notes" gave them no voting rights. Actually, the three individual appellants and their wives and brothers all transferred some property (land or money) to the corporation. All received equity interests of some kind, although not at exactly the same time, in the same transaction. *Camp Wolters Enterprises* v. *Commissioner,* 5 Cir., 1956, 230 F. 2d 555, 559 affirming 22 TC 737, 1954, cert. den. 352 U. S. 826. The Tax Court also observes that the Income Tax Regulations, § 1.351-1(a)(1) provide that the phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but also includes a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds expeditiously consistent with orderly procedure.

The Tax Court thus fixed the corporation's basis for its property at $100,000, a carry-over basis from the transferors, pursuant to § 362(a)(1).

The Tax Court found the payments to the three individual appellants were governed by § 302(d) and that to the extent of the corporation's earnings and profits, these should be treated as dividends.

After close scrutiny of the entire record, we conclude that the decisions of the Tax Court are correct and must be affirmed.

AFFIRMED.

APPENDIX B.

Opinion.

43 T. C. No. 51.

TAX COURT OF THE UNITED STATES.

Burr Oaks Corporation, et al.,[1] Petitioners *vs.* Commissioner of Internal Revenue, *Respondent.*

Docket Nos. 4771-62, 4772-62, 1581-63, 1583-63.

Filed February 11, 1965.

Three individuals acquired a tract of undeveloped land in 1957 for $100,000. They decided to subdivide and improve the land, and sell lots therefrom. They incorporated petitioner in 1959 and transferred the land to it. In return, each received what purported to be a two-year 6 percent promissory note in the principal amount of $110,000. The land was not worth more than $165,000 when so transferred. At approximately the same time, the wives or brothers of the three individuals transferred a total of $4,500 cash to petitioner and received common stock in petitioner. Although the wives and brothers were petitioner's only shareholders of record, they had nothing at all to do with petitioner's business, which was dominated and controlled by the three individuals. Petitioner was undercapitalized. Its prospects were speculative. Petitioner made certain distributions to the three individuals during 1959 with regard to their promissory notes. The notes, however, were not paid in full at

1. Proceedings of the following petitioners are consolidated herewith: A. Aaron Elkind and Rosella Elkind, Docket No. 4772-62; Harold A. Watkins and Fannie G. Watkins, Docket No. 1581-63; and Maurice Ritz and Esther Leah Ritz, Docket No. 1583-63.

their maturity date, but were extended. A portion of the principal balance on each of the notes was outstanding as of the trial herein. *Held,* the transfer of the land to petitioner is an equity contribution, and the purported promissory notes are in the nature of preferred stock. *Held, further,* the transfer of the land and the transfer of the cash were part of an integrated transaction immediately after which the transferors were "in control" of petitioner. That transaction is therefore governed by section 351. *Held, further,* petitioner has a substiuted basis for the land. *Held, further,* the distributions received by the three individuals during 1959 are essentially equivalent to dividends.

Thomas J. Donnelly, Jr., Samuel J. Recht, Herbert Morse, for the petitioners.

Denis J. Conlon, for the respondent.

OPINION.

Fay, *Judge*: Respondent, pursuant to a statutory notice of deficiency, determined deficiencies in the income tax of petitioner Burr Oaks Corporation for its taxable years ended September 30, 1958, 1959, and 1960, in the respective amounts of $15,067.26, $52,595.26 and $16,602.61. With regard to the various individual petitioners, respondent determined the following deficiencies in their respective income taxes:

Docket No.	Petitioners	Taxable Year Ended Dec. 31	Deficiency
4772-62	A. Aaron and Rosella Elkind	1958	$ 499.32
		1959	35,520.49
		1960	1,778.90
1581-63	Harold A. and Fannie G. Watkins	1959	30,386.55
1583-63	Maurice and Esther Leah Ritz	1959	37,702.90

(Petitioner Burr Oaks Corporation will hereinafter be referred to as the petitioner, and petitioners A. Aaron Elkind, Harold A. Watkins, and Maurice Ritz will hereinafter sometimes be referred to respectively as Elkind, Watkins, and Ritz, or as the individual petitioners.)

The only question[2] remaining to be determined in so far as petitioner is concerned is its correct basis in certain unimproved real estate transferred to it by Elkind, Watkins, and Ritz. In order to make this determination, we must first decide whether the transfer by Elkind, Watkins, and Ritz to petitioner constituted a valid sale or a contribution to capital. In the event we find it to be the latter, we must further determine whether it constitutes a transfer to a controlled corporation within the meaning of section 351.[3]

In so far as petitioners Elkind, Watkins, and Ritz are concerned, we must determine whether certain amounts received by them during 1959 from petitioner were taxable as ordinary income, rather than as long-term capital gain.[4]

---

2. Respondent has conceded that certain costs incurred by petitioner should be allowed as current costs of sales rather than be allocated to several years as they were treated in the notice of deficiency. Petitioner has conceded that certain gains from the sale of lots, which it reported as received during its taxable year 1960, were properly reportable during its taxable year 1959. Petitioner's only contention with regard to those sales is that its basis for the lots sold should be higher than that determined by respondent.

3. Unless other wise indicated, all section references are to the Internal Revenue Code of 1954, as it existed during the taxable years in issue.

4. All other issues raised by the individual petitioners in their pleadings have been settled pursuant to agreement between the parties or have been conceded or abandoned.

Findings of Fact.

Some of the facts have been stipulated, and the stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

Petitioner is a corporation formed under the laws of the State of Wisconsin. It maintains its books of account and files its Federal income tax returns on the basis of an accrual method of accounting and a fiscal year ended September 30. It filed its Federal income tax returns for its fiscal years ended September 30, 1958 through 1960, with the district director of internal revenue at Milwaukee, Wisconsin.

A. Aaron and Rosella Elkind were, at all times relevant hereto, husband and wife. They filed joint Federal income tax returns for 1958, 1959, and 1960, prepared on the basis of a calendar year and the cash method of accounting, with the district director of internal revenue at Milwaukee, Wisconsin.

Harold A. and Fannie G. Watkins were, at all times relevant hereto, husband and wife. They filed a joint Federal income tax return for 1959, prepared on the basis of a calendar year and the cash method of accounting, with the district director of internal revenue, Milwaukee, Wisconsin.

Maurice and Esther Leah Ritz were, at all times relevant hereto, husband and wife. They filed a joint Federal income tax return for 1959, prepared on the basis of a calendar year and the cash method of accounting, with the district director of internal revenue at Milwaukee, Wisconsin.

Elkind, at all times relevant hereto, has been engaged in various aspects of real estate development, with primary emphasis on the development of tracts of one-family houses. These various endeavors were generally conducted through corporations in which Elkind or members of his

family were majority stockholders. Elkind also has made a number of investments in real estate, including raw land as well as improved property producing rental income.

Ritz, at all times relevant hereto, was a certified public accountant and the senior partner of an accounting firm of which Elkind was a client. Ritz had made various investments in improved and unimproved real estate prior to the years in issue herein, primarily as a result of opportunities which he came across in connection with his accounting practice.

At all times relevant hereto, Watkins was the president and principal stockholder of a corporation engaged in the manufacture and sale of slippers and other types of casual footwear. Watkins, also, had made several investments in real property over the years, primarily in improved properties producing rental income.

Elkind, Watkins, and Ritz have, at least upon one occasion other than that involved herein, jointly invested in a relatively large tract of unimproved real estate. Thus, on June 4, 1953, they purchased for the sum of $70,124.15 a tract of undeveloped land located just outside the city of Madison, Wisconsin. These individuals held that property (hereinafter referred to as the Gay Farm) jointly until April 20, 1954, at which time it was sold to one of Elkind's development corporations for the sum of $149,650.79. That corporation subdivided the property into 353 lots, constructed one-family homes thereon, and made substantial profits totaling approximately $500,000 upon their sale.

In the fall of 1954 Elkind came across the opportunity to purchase a similar piece of property, this time a tract of land of approximately 70 acres, also located near the outskirts of the city of Madison and theretofore used as a golf course. (This property will hereinafter sometimes be referred to as the Burr Oaks property.)

Elkind, in December of the same year, contacted Ritz and Watkins in regard to their participation with him in the purchase of that land. Watkins and Ritz agreed to join him in the acquisition upon the understanding that each of them would obtain a one-third interest therein. On December 7 of that year, Elkind tendered to the owner of said property a written offer to purchase the property for the sum of $100,000. The offer provided that $10,000 of the purchase price was payable at the time of acceptance, $10,000 on February 15, 1955, $5,000 on April 1, 1955, with payments of $5,000 due quarterly thereafter until the final balance was paid. The offer was accepted on December 8, 1954.

From the time they acquired the Burr Oaks property through the summer of 1957 Elkind, Watkins, and Ritz attempted to develop said property as a shopping center site or as an industrial park. In furtherance of this plan, they purchased in 1955 an additional 80 feet of frontage on an adjoining thoroughfare for the purpose of providing better access to the Burr Oaks property in the event of its commercial development. (This 80 feet of frontage will hereinafter be referred to as the Brinkman property.) Their efforts to develop the Burr Oaks property for commercial purposes, however, proved fruitless.

Sometime during 1957 Elkind became convinced that their plans to develop the Burr Oaks property as a shopping center or an industrial park would not materialize. Contemplating that one of his corporations might purchase the property for purposes of subdivision or development, Elkind requested two of his business associates to investigate the zoning and platting possibilities of the Burr Oaks property. On March 11, 1957, a petition was filed with the city council of Madison, Wisconsin, to change the zoning of the Burr Oaks property from residential "A" (single-family dwellings) to residential "A2" and "B" (two-

family and four-family dwellings) and commercial "A" and "B".

Elkind then proposed to Watkins and Ritz that the three of them sell the Burr Oaks property to one of Elkind's real estate corporations, as they had done with the Gay Farm property. Watkins and Ritz, recalling the substantial profits made by Elkind's corporation after they had sold the Gay Farm property to it, rejected this proposal. Ritz suggested that the three of them transfer the Burr Oaks property to a corporation which they would form for the purpose of subdividing, developing, and selling the property; that the shareholders thereof would be comprised of his two brothers and the wives of Watkins and Elkind; and that in return for the transfer of the land, the corporation would issue promissory notes to Elkind, Watkins, and Ritz. It was agreed that they would follow Ritz's suggestions.

On September 9, 1957, the city council of Madison approved a preliminary plat incorporating the zoning proposed for the property in the aforementioned petition filed on March 11, 1957. The land as platted contained 89 lots zoned for single-family dwellings (Residential "A"); 65 lots zoned for four-family apartments (Residential "B"); 110 lots zoned for multiple-family apartments (Residential "C"); 1 site zoned for commercial use; and 1 site zoned for a school. This zoning received final approval from the Madison city council on November 25, 1957.

Petitioner was incorporated on October 8, 1957, for the purpose of (1) acquiring the Burr Oaks property from Elkind, Watkins, and Ritz; (2) developing and subdividing said property; and (3) selling improved lots therefrom to customers. At the time petitioner was formed, the Burr Oaks property was completely unimproved. Elkind, Watkins, and Ritz were aware of a local ordinance pursuant to which owners of unimproved land could request the city of

Madison to make improvements thereon such as streets, sewers, water, and sidewalks. The city would make these improvements and assess the costs incurred in connection therewith against the property. However, it was realized that the cost of some of the improvements to be made, such as grading and supplying crushed stone, would have to be borne directly by the developers. The total cost of such improvements, as estimated by petitioner, was in the amount of $107,243.33.

It was determined by Ritz, Watkins, and Elkind that petitioner's initial capital would be $4,500.

Petitioner issued a total of 450 shares of its common stock to a group composed of Elkind's wife, Watkins' wife, and Ritz's brothers, Philip and Erwin, for an aggregate consideration of $4,500. Elkind's wife received 150 shares of the stock; Watkins' wife also received 150 shares; and Philip and Erwin Ritz each received 75 shares. The record does not indicate the exact date when this stock was issued. Philip and Erwin Ritz paid for their stock by their respective checks, each in the amount of $750 and dated October 9, 1957. Watkins' wife paid for her stock by a check in the amount of $1,500 dated October 14, 1957. Each of the above-mentioned four persons received from petitioner a receipt dated November 1, 1957, evidencing their payment for the stock. At all times relevant hereto, petitioner's stockholders of record and officers and directors were as follows:

Shareholder		No. of Shares Held
Rosella Elkind	(Elkind's wife)	150
Fannie G. Watkins	(Watkins' wife)	150
Philip M. Ritz	(Ritz's brother)	75
Erwin M. Ritz	(Ritz's brother)	75

Officers	Position Held
Watkins	President
Philip M. Ritz	Vice-president
Rosella Elkind	Secretary-treasurer

Directors

Watkins	Fannie G. Watkins
Ritz	Philip M. Ritz
Elkind	Rosella Elkind

Petitioner's articles of incorporation, at all times relevant hereto, provided:

> (c) Any stock that is hereafter issued by the corporation may be sold to such persons and at such prices but not less than such prices as may be determined by the majority of the Board of Directors, and without first offering any part of said stock to the then present holders of stock in the corporation.

On November 1, 1957, Elkind, Watkins, and Ritz transferred their respective interests in the Burr Oaks property to petitioner. In consideration for this transfer, petitioner assumed the remaining unpaid balance for the property, namely $30,000, and issued to each of Elkind, Watkins, and Ritz what purported on the face thereof to be a promissory note in the principal amount of $110,000. Each of the notes recited that it bore interest at the rate of 6 percent and that it was payable two years after the making thereof. The $30,000 obligation for the Burr Oaks property to its original owner, assumed by petitioner from Elkind, Watkins, and Ritz, was entered on petitioner's books under an account captioned "Mortgage Payable." An additional account was set up under the title "Land Contract Payable" in the amount of $330,000 to represent the alleged promissory notes. At the time Elkind, Watkins, and Ritz transferred the Burr Oaks property to petitioner, the fair market value of said prop-

erty was substantially less than $360,000. The property was not worth more than $165,000 at that time.

Although at the time Elkind, Watkins, and Ritz transferred their interests in said property to petitioner they hoped that petitioner's business would be successful, petitioner's prospects were uncertain. The nature of their investment can best be described by the term "speculative."

Shortly after its incorporation, petitioner found that it did not have sufficient funds on hand with which to commence operations. Therefore, on November 30, 1957, it borrowed $15,000 from Elkind. On February 28, 1958, Elkind loaned petitioner an additional $10,000. These loans, together with interest thereon in the amount of $1,859.78 were repaid on June 30, 1959.

None of petitioner's stockholders of record, namely Watkins' and Elkind's respective wives and Ritz's brothers, took any active interest in the management of petitioner. In fact, none of them had any real idea of the nature of petitioner's business, other than some vague notion that it was engaged in "real estate" in some way or other.

Watkins and Ritz hired Albert McGinnis to manage petitioner. His work included the supervision of the platting, development, and subdivision of the land, as well as taking charge of advertising and sales. McGinnis had known and worked for Elkind and his various corporations for approximately 15 years prior to that time as a lawyer and real estate broker and in various other capacities. McGinnis, moreover, was the person who first interested Elkind in purchasing the Burr Oaks property and checked into the zoning and platting possibilities for the land. During the years in issue, McGinnis continued to work for various Elkind interests.

Ritz's accounting firm, Ritz, Holman and Company, kept

petitioner's books and took care of its accounting work. McGinnis was required to account to Ritz, Holman and Company for the funds which he took in and disbursed in connection with his operation of petitioner's business.

Upon a number of occasions, petitioner transferred various lots or parcels of property to Elkind, Watkins, and Ritz, either at no cost or at a price less than the amount for which such lots could have been sold to third parties. Thus, by deed dated November 3, 1958, petitioner conveyed to Elkind, Watkins, and Ritz a strip of commercial property, 70 feet by 120 feet, located in the southeast corner of the Burr Oaks property. This property was contiguous with another piece of commercial property, the Brinkman property, which Elkind, Watkins, and Ritz had purchased when they were contemplating using Burr Oaks for a shopping center. Nothing was paid to petitioner in consideration for this transfer. The deed by which the transfer was effected purported on its face to correct an erroneous conveyance of the land to petitioner in the first place.

On November 14, 1958, petitioner sold five lots at a price of $3,000 per lot to the Leo Building Corporation, which was owned and controlled by Elkind and an associate of his. On the same date petitioner sold an additional five lots for the same price to Carsons, Inc., a corporation owned by Watkins. Petitioner, on May 20, 1960, sold five more lots at $3,000 per lot to M & L Investment, Inc., a corporation in which Ritz owned a substantial interest. Each of the lots involved in these transfers was zoned Residential B to accommodate four-family apartments. The evidence indicates that, at the time they were sold after having been platted, subdivided, and improved, each of these lots could have been sold to outsiders for $500 to $1,000 more than was received from the above corporations. None of petitioner's shareholders of record (Philip and Erwin

Ritz, Elkind's wife, or Watkins' wife) was consulted with regard to, or knew of, any of these transfers. Nor was any such transfer authorized by a meeting of petitioner's board of directors.

Although McGinnis was in charge of petitioner's day-to-day operations, Elkind, Watkins, and Ritz controlled and dominated petitioner's affairs.

During its taxable years 1958 through 1963, inclusive, petitioner had gross receipts in the following amounts as a result of its subdivision and sale of the Burr Oaks property:

Taxable Year Ended September 30	Gross Sales of Lots
1958	$ 86,095
1959	177,200
1960	118,625
1961	68,250
1962	49,400
1963	13,900
Total	$513,470

As had been contemplated by Elkind, Watkins, and Ritz at the time of petitioner's incorporation, improvements to the Burr Oaks property, such as streets, sewers, water, and sidewalks, were made by the city of Madison. The city was to recover the cost of these improvements by special assessments against the lots, which assessments were generally payable over a period of five to eight years. To the extent that installments of the special assessments came due prior to the sale of the lots, they were paid by petitioner and added to the price of the lots. To the extent the assessments had not been paid prior to the sale of the lots, they were assumed by the purchaser. Certain costs incurred in connection with the subdivision and improvement of the Burr Oaks property were borne directly by petitioner. These costs included the following: (1)

The cost of installing a sewer along one of the streets in the subdivision; (2) a surveying fee running from $25 to $40 per lot; and (3) the costs of grading and supplying crushed stone. The cost of improvements incurred by petitioner in subdividing the Burr Oaks property, including the special assessments paid by it, totaled $107,243.33.

In addition to the foregoing costs, petitioner during its taxable years ended September 30, 1958, through September 30, 1963, incurred the following operating expenses in connection with its subdivision and sale of the Burr Oaks property:

Taxable Year Ended September 30	Amount
1958	$21,281.61
1959	22,077.74
1960	20,217.49
1961	20,650.46
1962	21,182.44
1963	15,500.14

In the latter part of 1959 Elkind, Watkins and Ritz surrendered to petitioner the original "promissory notes" which they had received from petitioner in connection with their transfer of the Burr Oaks property. In return for the surrender of the notes, each of the individual petitioners received from petitioner a distribution of $23,000 in cash and a promissory note dated November 1, 1959, in the principal amount of $87,000. The new notes recited (1) that they were payable one year after the making thereof and (2) that they bore interest at the rate of 6 percent per annum. Later that same year, petitioner paid an additional $8,000 apiece to Elkind, Watkins, and Ritz. Petitioner at that time, in exchange for each of their notes in the principal amount of $87,000, issued to each of them a new promissory note in the principal amount of $79,000.

On December 29, 1959, petitioner purported to repay the outstanding balance on these "new promissory notes." At the close of business on that date petitioner had a bank balance of $5,398.88. The record does not clearly indicate how petitioner purported to repay these notes. However, the record does clearly indicate that petitioner urgently needed as working capital the $237,000 which it claims to have used to repay the three promissory notes.

Therefore, immediately after those notes were "repaid" Elkind, Watkins, and Ritz each "loaned" $79,000 to petitioner, and petitioner, in turn, issued to each of the individual petitioners a "new" one-year promissory note dated December 31, 1959, in the principal amount of $79,000. This transaction did not represent a repayment of the alleged "promissory notes." It was merely an extension of the purported maturity date. The individual petitioners never had any intention of enforcing their "notes" against petitioner.

In addition to the foregoing, petitioner made the following distributions to each of the individual petitioners with regard to the "promissory notes":

Date of Distribution	Amount paid to each of the individual Petitioners
August 31, 1960	$ 8,000
January 31, 1961	15,000
December 31, 1961	10,000

There was an aggregate balance of $138,000 outstanding upon the three "notes" at the time of the trial in this proceeding, or a total of $46,000 due upon each of said notes.

Petitioner has not distributed any of its earnings to any of the shareholders of record.

Elkind, Watkins, and Ritz treated their transfer of the Burr Oaks property to petitioner in November, 1957 as a

sale. Petitioner did likewise and set up on its books a cost of $360,000 for said property. Elkind, Watkins, and Ritz, however, did not report any gain with regard to this alleged sale until 1959 when petitioner purportedly paid in full the promissory notes which it had issued to them in connection with said transfer. In their respective income tax returns for 1959, each of them reported long-term capital gain in the amount of $85,729.06 as a result of their transfer of the Burr Oaks property to petitioner in 1957.

Respondent, pursuant to separate notices of deficiency issued to Elkind, Watkins, and Ritz with respect to their taxable year ended December 31, 1959, determined that

> the gain realized from the sale of (the Burr Oaks property) in the total amount of $85,729.06 is taxable as ordinary income rather than as long-term capital gains reported on your income tax return. * * *

Pursuant to a statutory notice of deficiency issued to petitioner with respect to its taxable years 1958 through 1960, respondent increased petitioner's taxable income for said years by an aggregate amount totaling $192,686.98. This increase was based on respondent's determination that petitioner had understated its income for those years by claiming too high a basis or cost in the land sold by it in that period. The notice of deficiency indicates that, in making his determination, respondent treated petitioner as having a basis of $100,000 in the Burr Oaks property, rather than a basis of $360,000, as petitioner had claimed.

Opinion.

There are two issues to be determined in this case. These are (1) petitioner's correct basis in the Burr Oaks property and (2) the proper tax treatment of the amounts received by Elkind, Watkins, and Ritz from petitioner during 1959. In order to resolve these issues, we must classify,

for tax purposes, the transaction wherein each of the individual petitioners in November, 1957 (1) transferred his respective interest in the Burr Oaks property to petitioner and (2) in return therefor received an instrument purporting to be a promissory note in the principal amount of $110,000.

It is contended by Elkind, Watkins, and Ritz (1) that their transfer of the Burr Oaks property to petitioner constitutes the sale or exchange of a capital asset held in excess of six months; (2) that the promissory note received by each of them in return therefor represents a valid indebtedness incurred by petitioner; and (3) that the gain realized by them in connection with said transfer is properly reportable in 1959 when they allege that petitioner "paid in full" the "promissory notes" which had been issued to them.[5]

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5. Passing over for the moment the validity of the first two parts of the individual petitioners' argument, we believe it appropriate to point out that the third part of their argument, namely, that the gain realized by them on the transfer of the Burr Oaks property was properly reportable in 1959, is incorrect. Watkins, Elkind, and Ritz at all times relevant hereto were cash basis taxpayers. When cash basis taxpayers sell property, they must include in income the fair market value of any property received in exchange therefor. This would include the fair market value of any notes received. See *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462 (1933). The individual petitioners have not advanced any of the arguments which would enable them to avoid the applicability of this general rule. Thus, they have made no argument that the "promissory notes" received by them were of indeterminate or unascertainable value or that the notes were not received by them in payment for the land. Cf. *Robert J. Dial*, 24 T. C. 117 (1955); *Jay A. Williams*, 28 T. C. 1000 (1957); and *Schlemmer* v. *United States*, 94 F. 2d 77 (C. A. 2, 1938). Nor do they contend (1) that the fair market value of the "notes" received by them was less than their respective bases in the land, cf. section 1.1001-1, Income Tax Regs., or (2) that the transfer was not a closed transaction, cf. *Joseph Marcello*, 43 T. C. 168 (1964). There is nothing in the record to show that (1) they elected to report the gain realized by them at the time of the transfer on the installment method or (2) that they were entitled to report their gain on the deferred-payment sale method. See section 1.453-4 (b) (1) and (2) and section 1.453-6, Income Tax Regs.

It is contended by petitioner that it purchased the Burr Oaks property from Elkind, Watkins, and Ritz at a cost of $360,000 and that such cost is its correct basis in said property.

The plethora of arguments advanced by respondent in his opening statement and on brief indicates to us that the Government had some difficulty in formulating a suitable rationale under which to classify the transfer of the Burr Oaks property to petitioner. It would serve no purpose to set forth at this point the various contentions made by respondent since we believe that the transaction was not a sale, but an equity contribution.[6]

It is true that Elkind, Watkins, and Ritz attempted to cast their transfer of the Burr Oaks property to petitioner

6. The statutory notices issued to the individual petitioners seem to be grounded on the theory that Elkind, Watkins, and Ritz were not entitled to report the sale of the Burr Oaks property as long-term capital gain since they were dealers. The deficiency notices did not raise any question with regard to the proper year for reporting the gain. In view of the fact that respondent, in the deficiency notice to petitioner-corporation, determined that petitioner's basis for the Burr Oaks property was the same as that of the transferors of the property, said statutory notice would seem to be based on the theory that the transfer was governed by section 351. This is undoubtedly what caused Elkind, Watkins, and Ritz to raise the following issue by way of amended petition:

> In the alternative, in the event the basis of the (Burr Oaks property) in the hands of (petitioner) is determined under section 351 of the Internal Revenue Code, respondent erred in failing to determine that petitioners had no taxable gain for the year 1959 as a result of the transfer of the said real estate to (petitioner).

We have concluded that the transfer of the Burr Oaks property to petitioner was not a sale on the basis of the clear, uncontroverted facts in the record and without resort to the burden of proof. Nevertheless, we believe it appropriate to point out that the petitioners Elkind, Watkins, and Ritz, as well as the Burr Oaks Corporation, have the burden of proof on this issue. For even if we were to regard the issue of whether the transfer of the property constitutes a bona fide sale as new matter in so far as Elkind, Watkins, and Ritz are concerned, they raised that question by way of their amended petition.

in the form of a sale. It is also true that, from a standpoint of form, the alleged promissory notes issued to the individual petitioners are clear evidences of indebtedness. However, it has often been noted in connection with similar issues, the substance of the transaction, rather than its form, is the controlling factor in the determination of the proper tax treatment to be accorded thereto. *Sherwood Memorial Gardens, Inc.*, 42 T. C. 211 (1964), on appeal (C. A. 7, Aug. 10, 1964); *1432 Broadway Corporation*, 4 T. C. 1158 (1945), affd. 160 F. 2d (C. A. 2, 1947). Whether a transaction such as the one we are now confronted with is in substance, as well as in form, a sale is essentially a question of fact. *Gooding Amusement Co.*, 23 T. C. 408 (1954), affd. 236 F. 2d 159 (C. A. 6, 1956), certiorari denied 352 U. S. 1031 (1957).

As we view the creditable evidence presently before us, the transfer of the Burr Oaks property to petitioner is so lacking in the essential characteristics of a sale and is replete with so many of the elements normally found in an equity contribution (*cf. Emanuel N. (Manny) Kolkey*, 27 T. C. 37 (1956), affd. 254 F. 2d 51 (C. A. 7, 1958), and *Bruce* v. *Knox*, 180 F. Supp. 907 (D. C. D. Minn. 1960)) that it appears to us as nothing more than a shabby attempt to withdraw from petitioner, at capital gains rates, the developer's profit normally inherent in the subdivision and sale of raw acreage such as the Burr Oaks property.

This Court has been required upon numerous occasions to determine the true nature of alleged sales or transfers of assets to corporations. In the *Kolkey* case, we listed the following questions as among the relevant criteria for making such a determination:

> Was the capital and credit structure of the new corporation realistic? What was the business purpose, if any, of organizing the new corporation? Were the noteholders the actual promoters and entrepreneurs

> of the new adventure? Did the noteholders bear the principal risks of loss attendant upon the adventure? Were payments of "principal and interest" on the notes subordinated to dividends and to the claims of creditors? Did the noteholders have substantial control over the business operations; and if so, was such control reserved to them as an integral part of the plan under which the notes were issued? Was the "price" of the properties, for which the notes were issued, disproportionate to the fair market value of such properties? Did the noteholders, when default of the notes occurred, attempt to enforce the obligations? [*Emanuel N. (Manny) Kolkey, supra,* at 59.]

We have set forth in our Findings of Fact, with some degree of specificity, the various factors which cause us to conclude that the transfer of the Burr Oaks property to petitioner was an equity contribution, rather than a sale. We set forth below some of the more significant factors which led us to this conclusion.

In the first place, petitioner, from the start of its existence, was not only undercapitalized, but, in fact, had no significant capitalization at all. Cf. *Hoguet Real Estate Corporation,* 30 T. C. 580 at 598 (1958). Thus, petitioner was organized in October with a paid-in capital of $4,500. Shortly thereafter, when Elkind, Watkins, and Ritz transferred the Burr Oaks property to petitioner, its books of account reflected liabilities of $360,000. In addition, it was contemplated from the very outset of petitioner's existence that although the city of Madison would initially pay the major portion of the cost of improving the Burr Oaks property, petitioner would, nevertheless, be required to incur substantial development costs. Petitioner estimated that these costs would be in excess of $100,000.

Another factor indicating that petitioner was undercapitalized and did not have sufficient funds with which to

commence business is that on November 30, 1957, less than two months after it was formed, it borrowed $15,000 from Elkind. On February 28, 1958, it borrowed an additional $10,000 from Elkind.

Moreover, the land transferred to petitioner by Elkind, Watkins, and Ritz was its only asset of significance and, without it, petitioner could not have engaged in business. See and compare *Edward G. Janeway*, 2 T. C. 197 (1943), affd. 147 F. 2d 602 (C. A. 2, 1945); *Aqualane Shores, Inc.*, 30 T. C. 519 (1958), affd. 269 F. 2d 116 (C. A. 5, 1959). It was at all times contemplated by Elkind, Watkins, and Ritz that the land would remain at the risk of petitioner's business.

It is generally recognized that one of the crucial factors in determining whether the transfer of property to a "thinly" capitalized corporation constitutes a bona fide sale, rather than a mere contribution to capital, is the anticipated source of payment to the transferor. *Gilbert* v. *Commissioner*, 262 F. 2d 512, 514 (C. A. 2, 1959), affirming a Memorandum Opinion of this Court, certiorari denied 359 U. S. 1002 (1959). If payment to the transferor is dependent solely upon the success of an untried, undercapitalized business, the prospects of which are uncertain, the transfer of property raises a strong inference that it is, in fact, an equity contribution. But cf. *Miller's Estate* v. *Commissioner*, 239 F. 2d 729 at 733 (C. A. 9, 1956), reversing 24 T. C. 923 (1955); *Sheldon Tauber*, 24 T. C. 179, 181-182 (1955); and *Ainslie Perrault*, 25 T. C. 439 (1955), affd. per curiam 244 F. 2d 408 (C. A. 10, 1957), where repayment of the notes involved was dependent upon the continued success of an established business with a good earnings record and excellent future prospects.

At the time of the transfer of the Burr Oaks property to petitioner, its business prospects can only be described

as speculative and uncertain.[7] Elkind, Watkins, and Ritz realized that the only way petitioner could raise the $100,000 needed by it for improvements would be from sales of lots. It is obvious that the only hope that Elkind, Watkins, and Ritz had of obtaining repayment of the so-called promissory notes depended upon the successful development and sale of the lots in the Burr Oaks property.

Despite the fact that the respective interests of Elkind, Watkins, and Ritz in petitioner were represented by what purported on their face to be promissory notes in the principal amount of $110,000, the evidence before us indicates that it was the intent of all concerned with the affairs of petitioner that these instruments would give Elkind, Watkins, and Ritz a continuing interest in petitioner's business. The instruments issued by petitioner to Elkind, Watkins, and Ritz recited that they were to mature in two years from the date of issuance. However, after a review of the entire record, we believe that it was understood that no payment would be made on the notes, or would ever be demanded by Elkind, Watkins, and Ritz which in any way would weaken or undermine petitioner's business. See *Charter Wire, Inc.* v. *United States*, 309 F. 2d 878 at 881 (C. A. 7, 1962). It is true that petitioner during 1959 paid $31,000 apiece to Elkind, Watkins, and Ritz with respect to their so-called promissory notes.[8]

7. It was argued on behalf of petitioner and Watkins, Elkind, and Ritz that at the time of the transfer of the property to petitioner a number of lots were ready for sale and that because of the money that could be derived therefrom petitioner did not need a great deal of capital at the time of its incorporation. However, there was no assurance that petitioner would be able to sell any of these lots right away. As matters actually developed, petitioner encountered difficulty in selling lots after it was formed, which caused it to borrow money from Elkind.

8. On brief, it is argued on behalf of the various petitioners herein that the series of exchanges of notes that occurred at the end of December 1959 between Elkind, Watkins, and Ritz, on the

However, petitioner's history with regard to making payments on the alleged promissory notes indicates that the payments thereon came only from gains derived through the sale of lots. Moreover, the fact that there was outstanding a substantial principal balance ($46,000) on each of the notes issued to the individual petitioners even as late as the time of the trial herein indicates that the alleged notes were intended to give the individual petitioners a continuing equity interest in petitioner. See *Charter Wire Inc.* v. *United States, supra,* at 881.

The evidence clearly indicates that although Elkind, Watkins, and Ritz were not stockholders of record in petitioner, nevertheless, they completely dominated and controlled petitioner's affairs. Watkins was petitioner's president. Petitioner's board of directors consisted of Elkind, his wife, Ritz, his brother Philip, Watkins, and Watkins' wife. McGinnis the man who ran petitioner's day-to-day affairs had been employed by Elkind in one capacity or another for a period of at least 15 years. His activities were generally supervised by Ritz's accounting firm. After listening to his testimony and that of Elkind, Watkins, and Ritz, we are convinced that McGinnis operated petitioner in accordance with their wishes.

Petitioner's shareholders of record consisted of Ritz's brothers Philip and Erwin, Elkind's wife, and Watkins' wife. They knew and understood little if anything of the nature of petitioner's business. Moreover, after listening to the testimony at the trial, it was obvious to us that

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one hand, and petitioner, on the other, constituted a repayment by petitioner of the "unpaid principal balance" in the amount of $79,000 on each of the alleged promissory notes, followed immediately by an advance of a similar amount by each of the individual petitioners. This alleged repayment by petitioner of an aggregate of $237,000 took place at a time when petitioner's liquid assets totaled less than $5,500. It is too much to ask this Court to believe that such an obvious sham constituted a repayment of the alleged notes. Cf. *Arthur L. Kniffen,* 39 T. C. 553, 565-566 (1962).

they were subject to the control of Elkind, Watkins, and Ritz.

By virtue of the provision in petitioner's articles of incorporation regarding the issuance of additional shares of common stock at such prices as a majority of the board of directors should determine, Elkind, Watkins, and Ritz were in a position to appropriate to themselves (through the issuance of additional common stock at whatever price they chose) substantialy all of the profits that petitioner might realize after repaying its purported indebtedness to them.

The record also indicates that in transferring the Burr Oaks property to petitioner, Elkind, Watkins, and Ritz assigned a highly inflated value to said property.[9] Cf. *Emanuel N. (Manny) Kolkey, supra,* at 61. The transfer of the Burr Oaks property to petitioner seems to us an integral part of a plan devised by Ritz whereby Ritz, Watkins, and Elkind could obtain an assured participation in the fruits of the development and subdivision of said property. See *Bruce* v. *Knox, supra,* at 912. Watkins and Ritz both admitted that petitioner was formed in order to allow them to receive some part of the development profits. The inflation of the "sales price" to petitioner served to extend the period during which Elkind, Watkins and Ritz could participate in petitioner's business as "creditors" and increased the amount which they could withdraw as "principal" if the venture proved successful.

These are some of the factors which led us to conclude

9. An expert witness introduced by petitioner testified that the Burr Oaks property was worth at least $360,000 when it was transferred to petitioner in November of 1957. However, we found the evidence presented by respondent's expert witness that the property had a fair market value of approximately $125,000 far more convincing, although not fully persuasive. On the basis of the evidence before us, we found the Burr Oaks property to have a fair market value of not more than $165,000 at the time of its transfer to petitioner.

that the promissory notes received by Elkind, Watkins, and Ritz did not represent a true indebtedness. The purported promissory notes issued to the individual petitioners in our opinion constitute preferred stock.[10] See *1432 Broadway Corporation, supra*, at 1166; *Foresum, Inc.*, 41 T. C. 706, 717 (1964), on appeal (C. A. 6, Apr. 20, 1964); and *Sherwood Memorial Gardens, Inc., supra*, at 230.

Having decided that for tax purposes the so-called promissory notes issued to Elkind, Watkins, and Ritz constitute an equity interest in petitioner, we must now determine whether the transfer of the Burr Oaks property is governed by section 351.

Section 351 deals with transfers of property to a corporation controlled by the transferor or transferors. In pertinent part that section provides:

> (a) * * * No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. * * *

Section 368(c) defines "control" for purposes of section 351 as meaning "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

In contending that section 351 does not govern the trans-

10. Although we have found the purported promissory notes to constitute equity interests in petitioner for tax purposes, we believe that the holders of those instruments occupied a preferred position vis-a-vis the holders of the common stock. In the first place, the purported promissory notes called for the payment of interest at 6 percent a year. This provision constituted a prior charge on the earnings of petitioner in favor of the holders of those instruments, not unlike a preferred dividend. Thus, we regard the purported promissory notes as preferred stock.

fer of the Burr Oaks property, petitioner has presented three arguments. Two of these arguments (that the transaction was a sale and that no stock or securities were issued to the transferors of the property) have been previously considered and resolved adversely to petitioner. The third argument presented is that Elkind, Watkins, and Ritz, who transferred the Burr Oaks property to petitioner were not, immediately after that transaction, in control of that corporation within the meaning of the term "control" as defined in section 368(c). Thus, it is contended that even if the promissory notes held by Elkind, Watkins, and Ritz constituted stock, that stock did not carry with it any voting rights. Petitioner further points out (1) that pursuant to its bylaws the right to vote was reserved exclusively to the shareholders of record, namely, Elkind's wife, Watkins' wife, and Ritz's two brothers, and (2) that, for the above reason, the transferors of the Burr Oaks property (Elkind, Watkins, and Ritz) failed to comply with the control requirements set forth in section 368(c) because they did not possess "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote." There is a basic fallacy in petitioner's argument in that it is premised on the assumption that Elkind, Watkins, and Ritz were the only transferors of property to petitioner.

As we view the transaction, Elkind, Watkins, and Ritz acted together with Elkind's wife, Watkins' wife, and Ritz's two brothers in forming petitioner. The record clearly indicates that each of them transferred property to petitioner. As we have previously found, Elkind's wife, Watkins' wife, and Philip and Erwin Ritz transferred to petitioner a total of $4,500 shortly after its incorporation. It is settled law that money constitutes property for purposes of section 351. *American Bantam Car Co.*, 11 T. C. 397 (1948), affd. per curiam 177 F. 2d 513 (C. A. 3, 1949),

certiorari denied 339 U. S. 920 (1950). In return therefor, petitioner issued to them an aggregate of 450 shares of its common stock. Shortly thereafter, Elkind, Watkins, and Ritz transferred to petitioner their respective interests in the Burr Oaks property and, in return, received what on its face purported to be promissory notes, but what we have previously determined to be preferred stock.

Although Elkind, Watkins, and Ritz may not have received their preferred stock interests in petitioner at exactly the same time as the common stock was issued to Ritz's brothers and the respective wives of Elkind and Watkins, it seems clear that the transfers of cash and the Burr Oaks property to petitioner were integral parts of a unified transaction. *Camp Wolters Enterprises* v. *Commissioner,* 230 F. 2d 555, 559 (C. A. 5, 1956), affirming 22 T. C. 737 (1954), certiorari denied 352 U. S. 826 (1956). See also section 1.351-1(a)(1), Income Tax Regs., which provides:

> The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. * * *

On the basis of the record before us, it appears to us that Elkind, Watkins, and Ritz, together with Ritz's brothers, Elkind's wife, and Watkins' wife, were in control of petitioner, as defined in section 368(c), immediately after their transfer of property to it. The fact that Elkind, Watkins, and Ritz received no common stock, which according to petitioner's articles of incorporation was the only class of stock entitled to vote, is of no significance; for there is no requirement in section 351 that each transferor receive voting stock for that section to be applicable.

See *Cyrus S. Eaton,* 37 B. T. A. 715 (1938), which in-

volved the transfer of property by two persons to a controlled corporation. One transferor therein received only common stock and the other received only non-voting preferred. In commenting upon the question of control, we stated: "Inasmuch as the transferors * * * owned all of the stock of the corporation, they have the necessary control required by the statute."[11] See also *Gus Russell, Inc.*, 36 T. C. 965 (1961).

Since the nonrecognition provisions of section 351 apply to the transfer of the Burr Oaks property to petitioner, petitioner's basis in said property is limited to $100,000, which is a carryover basis from the transferors. Section 362(a) (1).[12]

In so far as the distributions made by petitioner during 1959 to Elkind, Watkins, and Ritz are concerned, we have previously found that, to the extent they purported to be a repayment of the "promissory notes," they were a sham. The net effect of the various payments by petitioner and exchanges of notes was that petitioner distributed $31,000 apiece to Elkind, Watkins, and Ritz in 1959. To this extent, the distributions resemble a redemption of stock in

11. This Court ultimately held that the nonrecognition provisions of section 112(b), I. R. C. 1939 (the predecessor of section 351), did not apply because the transferors failed to comply with the provisions of the "substantially proportionate" test which Congress deleted from the section when it was reenacted as section 351, I. R. C. 1954.

12. Sec. 362. Basis to Corporations.

(a) Property Acquired by Issuance of Stock or as Paid-In Surplus.—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies,

* * * * * *

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

that the respective interests of these individuals in petitioner were proportionately lessened. However, we are unable to find that said distributions fit within any of the paragraphs of section 302(b). Therefore, the $31,000 distributed by petitioner to Watkins, Elkind, and Ritz is governed by section 302(d) and to the extent of petitioner's earnings and profits is to be treated as a dividend.[13]

Decisions will be entered under Rule 50.

13. Petitioner's earnings and profits for the taxable years relevant hereto will be determined in the Rule 50 computation.

APPENDIX C.

Denial by Court of Appeals for Seventh Circuit of Petition for Rehearing and Review en Banc.

UNITED STATES COURT OF APPEALS

For the Seventh Circuit,

Chicago, Illinois 60604.

Tuesday, August 16, 1966.

Before

Hon. John S. Hastings, Chief Judge;
Hon. Elmer J. Schnackenberg, Circuit Judge;
Hon. Win G. Knoch, Circuit Judge;
Hon. Latham Castle, Circuit Judge;
Hon. Roger J. Kiley, Circuit Judge;
Hon. Luther M. Swygert, Circuit Judge.

No. 15344, 45, 46, 47.

BURR OAKS CORPORATION, *et al.*, *Petitioners*,
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petitions for review of a decision of the Tax Court of the United States.

IT IS ORDERED by the Court sitting en banc that the petition for rehearing and review en banc filed herein in the above entitled causes, be, and the same is hereby Denied.

APPENDIX D.

Sections of Internal Revenue Code of 1954.

SEC. 301. Distribution of Property.

Sec. 301(a).

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

SEC. 302. Distributions in Redemption of Stock.

Sec. 302(d).

(d) REDEMPTIONS TREATED AS DISTRIBUTIONS OF PROPERTY—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

SEC. 351. Transfer to Corporation Controlled by Transferor.

Sec. 351(a).

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

Sec. 351(b).

(b) RECEIPT OF PROPERTY.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

Sec. 351(c).

(c) SPECIAL RULE.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

Sec. 351(d).

(d) CROSS REFERENCES.—

(1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.

(2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362.

(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.

(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61(a)(1).

SEC. 1222. Other Terms Relating to Capital Gains and Losses.

For purposes of this subtitle—

(1) • • •

(2) • • •

(3) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

APPENDIX E.

Treasury Department Regulations Under Internal Revenue Code of 1954.

SECTION 1.317-1. PROPERTY DEFINED.

The term "property", for purposes of part 1, subchapter C, chapter 1 of the Code, means any property (including money, securities, and indebtedness to the corporation) other than stock, or rights to acquire stock, in the corporation making the distribution.